

August 2010
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- During the second quarter of 2010, the Romanian GDP fell by only 0.5% yoy.
- The consolidated budget deficit stood at 3.4% of projected full year GDP.
- In July 2010, the CPI increased by 7.1% yoy.
- In the first half of 2010, the trade in goods deficit narrowed by 7% yoy to EUR 3 billion.

Executive Summary

During the second quarter of 2010, the Romanian economy showed some improvement, with the rate of decline in real GDP growth at only 0.5% yoy, compared to a decline of 2.6% yoy in the first quarter of the year. Nevertheless, the outlook for the second half of 2010 has worsened. The main reason for the poor outlook is the severity of the government's fiscal austerity measures introduced to comply with the IMF requirement to contain the fiscal deficit to 6.8% of GDP. In addition, bad weather conditions and an uncertain global economic outlook play a negative role. The fiscal austerity programs - including a hike of the VAT rate by 5 p.p. to 24% and the reductions of state wages and transfers (by 25% and 20%) - are likely to hinder the recovery of domestic demand. As a result, real GDP is forecast to decline by 2%-3% for the whole year.

During the first half of 2010, the Romanian consolidated fiscal budget deficit widened by 26% yoy and

reached EUR 4.3 billion or 3.4% of annual GDP. By enforcing the above measures, the Romanian authorities made the fiscal deficit target of 6.8% of GDP more realistic. Without these measures, the fiscal deficit could have reached 9% of GDP in 2010. These policy actions have reopened access to IMF and EU loans. As a result, fiscal consolidation had a positive impact on Balance of Payments and caused the Romanian forex market to stabilize in July.

In July, consumer price inflation accelerated to 7.1% yoy due to the increase in the VAT rate. As a result, the CPI exceeded the target range (2.5% - 4.5%) and prompted the NBR to revise upward its end-of-period CPI forecast to 7.8% yoy. However, since the rise of inflation was not a monetary phenomenon but only a one-off factor, CPI is forecast to return to a downward path towards the end of 2010.

	2005	2006	2007	2008	2009	2010f
GDP growth, % change yoy	4.2	7.9	6.3	7.1	-7.2	-2.5
Industrial production, % change yoy	2.0	7.1	5.4	0.9	-5.5	3.0
Consolidated budget deficit, % of GDP	-0.8	-1.7	-2.4	-4.8	-7.2	-7.0
Unemployment, end of period		5.2	4.1	4.4	7.8	8.5
Inflation, end of period	8.72	4.87	6.56	6.30	4.75	7.8
Retail sales, % change yoy	17.5	13.5	17.8	13.0	-8.5	2.0
Gross forex reserves of the NBR, EUR billion, end of period	18.3	22.9	25.3	28.3	30.9	34.8
Current Account Balance, EUR billion	-6.89	-9.97	-16.68	-16.16	-5.05	-6.5
Total gross external debt, EUR billion	30.9	41.2	58.6	72.4	78.7	88
Exchange rate, RON/EUR, annual average	3.62	3.52	3.34	3.68	4.24	4.4

Source: INNSE, NBR, The Bleyzer Foundation

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Economic Growth

According to preliminary estimates of the Romanian National Institute of Statistics, real GDP contracted by 1.5% yoy during the first half of 2010. In the second quarter of the year, the pace of economic decline decelerated notably, as real GDP growth was estimated at -0.5% yoy compared to -2.6% yoy in the first quarter of 2010. Nevertheless, despite the second quarter improvement, the overall prospects for the Romanian economy in the second half of 2010 have recently worsened.

The main reasons for the worse outlook are the government's fiscal austerity measures introduced to comply with IMF requirements to contain the fiscal deficit to 6.8% of GDP, bad weather conditions and an uncertain global economic outlook.

Thus, most international financial institutions (IMF, EBRD, WB, etc.) downgraded the 2010 annual forecast for Romania's GDP growth to about -2% yoy from a previous rate of 0% yoy.

In June 2010, industrial production continued to accelerate, maintaining the overall upward path achieved during March-June. Indeed, the industrial production index rose by 6.7% yoy up from 5.9% yoy in May, bringing the cumulative half-year growth to 5.6% yoy. Strong industrial production in June was led by chemicals, basic metals and vehicles - 19% yoy, 53% and 27% yoy respectively. At the same time, manufacturing of food and beverages declined by 10% and 3%, reflecting still weak domestic demand.

The construction sector started to improve in June. In fact, the rate of decline of the construction works index eased by 5% yoy in June, compared with a decline of 17% yoy in the previous month. This improvement was achieved thanks to a lower decline of new construction works (by 12% yoy as compared to 28% yoy in May) and a positive growth of capital repairs works (by 32% yoy). The slower decline of new construction works might be explained by a revival of credit activity. However, the potential recovery of the construction sector might be subdued in the second half of the year due to the restricted fiscal budget as a result of fiscal austerity measures.

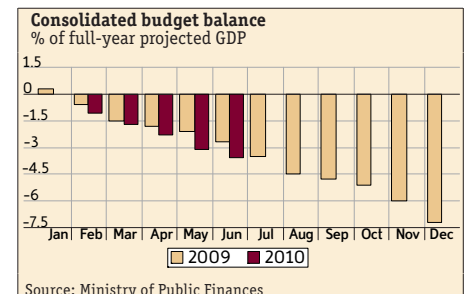
For the first time since November 2008, retail sales posted an increase, advancing by almost 5% yoy in June 2010. Such a remarkable growth in domestic consumption amid a 4% yoy in decline on average for the first six months of the year and still weak credit activity was primarily attributed to the announced government decision to hike VAT rate at the beginning of July. As a result, rushed consumers bought more durables (5% yoy in June compared to -3.6% yoy in May) and vehicles (8.4% yoy in June compared to -8.8% yoy in May). After the implementation of VAT tax increase and due to a wage reduction for public sector employees (by 25% starting in August), retail sales are set to decline in the coming months.

Given the above development, we maintain our forecast of real GDP decline at 2%-3% yoy. The Romanian economy is expected to return to growth in 2011.

Fiscal Policy

The consolidated budget deficit continued to expand in the first half of the year. In fact, the deficit widened by 26% yoy in the first half of 2010 and reached 3.4% of forecasted annual GDP (EUR 4.3 billion) as compared to 2.9 % posted in the first half of 2009.

Total revenues in nominal terms remained virtually unchanged during the first half of the year (around EUR 18.3 billion), while total expenditures grew by 4% yoy to EUR 22.5 billion. On the revenue side, tax collection, which accounted for more than half of total budget revenues, dropped by a nominal 2.4% yoy. In particular, the corporate profit tax, wage and income tax and VAT plummeted by 3% yoy, 5% yoy and 4% yoy, respectively. On the expenditure side, the rise in budgetary expenditures was led by large transfers to the population that grew by 14.6% yoy over the period.



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To meet the IMF's requirements to contain the fiscal deficit at 6.8% of GDP, the Romanian authorities implemented several fiscal austerity measures in June-July. In particular, they cut public wages and transfers by 25% and 20%, respectively. As the Romanian Constitutional Court ruled the reduction of pension benefits by 15% to be illegal, the government had to raise the VAT rate by 5 p.p. to 24% on July 1st. As a result of the austerity program, Romania might achieve a budget deficit around 3% of GDP in 2012. These fiscal consolidation measures are essential for Romania, as otherwise the budget deficit could have reached 9% of GDP for 2010. Lower budget deficits will allow the country to contain the growth of public debt, which had increased significantly during the last 5 years. Even though this fiscal policy is extremely unpopular, its implementation is necessary to sustain public finances and build credibility in Romania's debt service capacity. However, to enhance recovery and sustain economic growth in the future, the current fiscal austerity measures should be accompanied by a number of structural reforms to improve efficiency and encourage investments. In particular, measures to boost productivity of the public sector, improve the investment climate and pursue pension reform are on the agenda.

Total public and publicly guaranteed debt surged by 43% yoy to EUR 42 billion as of June 2010. As a result, the debt-to-GDP ratio reached 35% of GDP, while it was only 23% of GDP in the corresponding period a year ago. Given the IMF and EU program in place, total Romanian public debt is forecast to reach about 37% of GDP at the end of 2010.

Monetary Policy

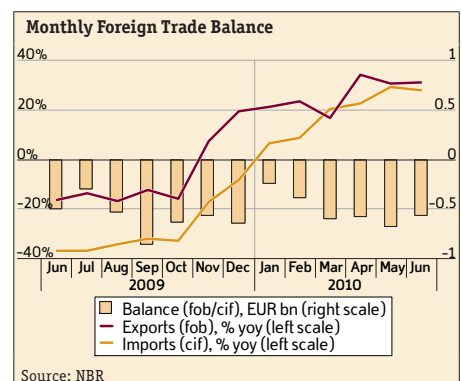
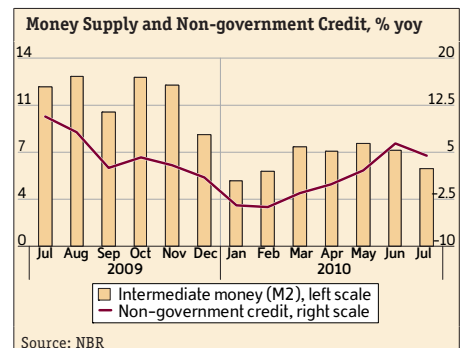
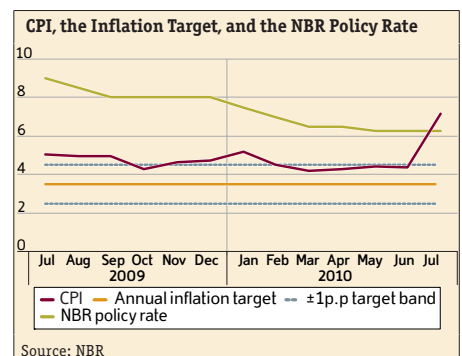
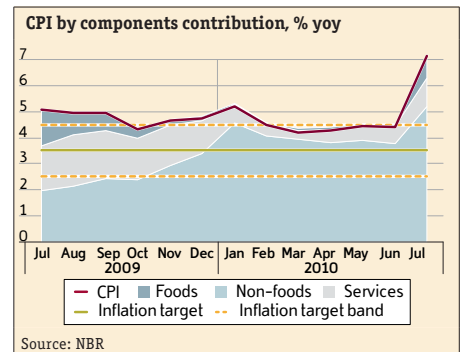
In July 2010, the CPI soared to 7.1% yoy, up from 4.4% yoy in June, exceeding the upper end of the inflation targeting band, set at 4.5%. The implementation of the VAT tax rate increase by 5 p.p. in July spurred price growth within all components of the consumer price index. In particular, prices on foods, non-foods and services were up by 2.3% yoy, 11.6% yoy and 6.1% yoy compared to -0.1% yoy, 8.4% yoy and 3.8% yoy a month before.

As a result, the National Bank of Romania upgraded its annual inflation forecast to 7.8% up from 3.7%. However, since the rise of inflation was not a monetary phenomenon but a one-shot factor, the CPI is forecast to return to a downward path at the end of 2010. Furthermore, the slow recovery of domestic demand and fiscal consolidation measures adopted by the government will contribute to bringing back inflation into the target range set at 2% -4% yoy in 2011.

Despite a surge in inflation in July, the NBR continued to keep the key monetary policy rate unchanged at 6.25% per annum. However, the NBR said that it reserved the right to raise the interest rate if inflation remains persistently high. At the same time, credit activity continued to revive in July. In particular, the stock of non-government credit increased three months in a row, demonstrating in June the highest growth rate since August 2009 - up by 6.4% yoy to EUR 50 billion.

International Trade and Capital

In the first half of 2010, the deficit in the trade of goods narrowed by 7% yoy to EUR 3 billion. In particular, export of goods soared by 26% yoy to EUR 17.2 billion during the first half of the year. The rise of export of goods in H1 was primarily driven by growth of export of transport equipments and vehicles and manufactured goods and raw materials - by 27%



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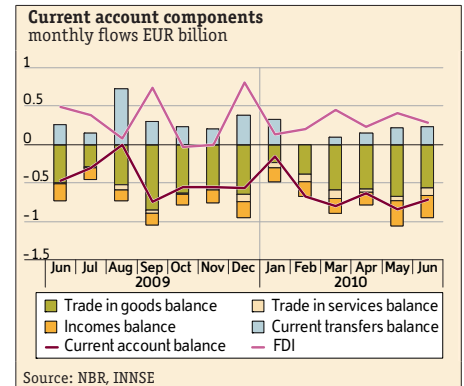
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yoy and 26% yoy respectively. At the same time, import of goods surged by 19% yoy in H1 to EUR 20.2 billion. The growth of import of transport equipment and vehicles together with import of manufactured goods and raw materials by 24% and 17% yoy, respectively, were the main drivers of increasing the import of goods in H1. However, a further expansion of the trade deficit is unlikely because of weak domestic demand and hikes in prices followed the increase of the VAT rate by 5 p.p.

In the first half of 2010, the current account deficit increased by 57% yoy and reached EUR 3.8 billion (roughly 3% of projected GDP). The worsening of the CA gap during H1 was led by a significant drop of current transfers by 50% yoy to EUR 1.1 billion. Only half of the current account deficit was funded by FDI as it declined by 29% yoy (around EUR 1.8 billion). Another half of the gap was financed by funds received from the IMF, EU and WB.

Since international financing is necessary to cover Romania's current account deficit, the government is likely to satisfy IMF requirements for the next tranche. As a result, the 6th IMF disbursement is anticipated in September. Moreover, the European Commission mission confirmed that all conditions for the third tranche of the EU BoP assistance programme were satisfied. Thus, Romania is also expected to receive EUR 1.2 billion out of a total EUR 5 billion for the EU financial assistance program.

Due to large repayments of public and publicly guaranteed external debt in July, forex outflows (EUR 3.1 billion) exceeded inflows (EUR 3.05 billion), despite a EUR 0.9 billion IMF disbursement. As a result, the National Bank of Romania's international reserves slightly declined and reached EUR 34.5 billion. At the same time, the Romanian currency (leu) remained quite stable.



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